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SUBJECT: SOUTH AFRICA ECONOMIC NEWSLETTER
January 7 2005 ISSUE

¶1. Summary. Each week, AMEmbassy Pretoria publishes an economic newsletter based on South African press reports. Comments and analysis do not necessarily reflect the opinion of the U.S. Government. Topics of this week's newsletter are:
- IMF Report on South African Investment;
- Government Set to Meet 3.2 Percent Budget Deficit Target;
- Gasoline Prices to Decline in February;
- Economic Forecasts for 2005; and
- Service Sector SETA Faces Funding Crisis.
End Summary.

IMF REPORT ON SOUTH AFRICAN INVESTMENT

¶2. A recent study by the International Monetary Fund (IMF) highlights South Africa's foreign investment profile from 1994 to 2002. South Africa has had no problem attracting foreign investment, however, the type of investment that it attracts is worrying from an economic growth perspective. South Africa attracts far less foreign direct investment (FDI) compared to emerging peer countries such as Thailand, Malaysia, Mexico, Poland and South Korea. However, South Africa surpasses other emerging market economies in attracting portfolio investment. According to the IMF study, during the period 1994 to 2002, average net inflows of FDI into SA amounted to 1.5 percent of gross domestic product (GDP), compared with just 3 percent of GDP in 16 other emerging markets. Excluding the large FDI transactions, such as Telkom's partial privatization in 1997 and the Anglo American takeover of De Beers in 2001, FDI fell to an average of 0.7 percent of GDP over the eight-year period. During 1994 to 2002, the share of foreign investment in capital flows was 88 percent in other peer countries, while the FDI share amounted to only 30 percent in South Africa. Although the FDI share in SA has increased to 50 percent during the 2000 to 2002 period, mostly due to the slowdown in equity flows, it remains well below that in other emerging market countries. Because of its long -term horizon, FDI is more conducive to economic growth and job creation by helping the transfer of technology and improving the skill levels of the labor force. The study shows that South Africa attracts far more portfolio investment than its peers, with inflows as a proportion of GDP amounting to almost double that of other emerging markets. During the period 1997 to 2000, portfolio inflows into South Africa averaged 5 percent of GDP, with South Africa benefiting from an exodus of capital from Asia during that period. According the study, more than 70 percent of portfolio inflows during the period 1994 to 2002 went into the equity market, with SA attracting more equity flows than other emerging markets. The IMF study shows that South Africa's trade openness is far lower than other emerging markets. Other factors where South Africa ranks low are its economic growth performance, infrastructure and crime levels. The study also shows that exchange rate volatility has a crucial role to play, with lower volatility likely to boost FDI, but probably reduce portfolio investment. The rand is one of the most volatile currencies in the world. The currency has doubled in value against the dollar after reaching a record low of R13.85/$1 in December 2001. The IMF says the South African Reserve Bank's (SARB) steady build-up of foreign exchange reserves will help reduce exchange rate volatility. In 2004, SARB eliminated its foreign exchange debt leading to recent increases in its gross reserves, although the level of reserves remain low compared to other emerging markets. Source: Business Day, January 5; IMF Country Report No. 04/379.

GOVERNMENT SET TO MEET 3.2 PERCENT BUDGET DEFICIT TARGET
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¶3. The government expects to meet its revised deficit target of 3.2 percent of gross domestic product this fiscal year, according to consultancy Econometrix.

Government revenue grew 17.9 percent in November, substantially higher than the full year budgeted revenue growth of 9.6 percent. November's revenue growth meant that revenue for the first eight months of the 2004/05 fiscal year increased 11.7 percent. Company tax revenue fell sharply, but growth in personal tax revenue, transfer duties, excise duties and the fuel levy more than made up for low corporate tax growth. Government expenditure in November increased 16.1 percent y/y, above the full year budgeted growth of 13.1 percent. Growth in expenditure for the first eight months was 11.2 percent, less than the budgeted growth rate. Econometrix predicts little problem in financing its increased infrastructural spending in the current fiscal year, although future infrastructural spending needs are significant. Source: Business Report, January 4.

GASOLINE PRICES TO DECLINE IN FEBRUARY

¶4. The Department of Minerals and Energy announced that the retail price of 97 octane unleaded petrol is anticipated to drop by 52 rand cents a liter, and the wholesale price of diesel containing 0.05 percent sulphur to decrease by 39 rand cents a liter in February. Unleaded and leaded 93-octane petrol should decrease by 44 rand cents a liter. Even though fuel prices should significantly decline in February, corresponding decreases in transport and food prices are not expected because of sustained consumer spending and fuel costs being a small percentage of input costs. Expectations for food prices and transport costs remain constant due to increased maintenance costs and wage pressures. Source: Pretoria News, January 4.

ECONOMIC FORECASTS FOR 2005

¶5. Many economists and analysts did not predict the rand's crash at the end of 2001, and most did not foresee the rand's subsequent strength. But after three successive years of gains, analysts have come around to the view that the rand's strength may continue. ABSA bank economist Karen Smith-Ford says the rand could end the year at about R5.63 to the dollar, similar to its current trading levels. The dollar will be the wild card this year with more weakness expected because of the U.S. economy's current account and fiscal deficits. A sharp move in the dollar poses the risk of boosting the rand further into overvalued territory, and putting more strain on the export sector as exports become less uncompetitive. The strong rand, however, will continue to be good news for inflation, as import prices remain low and domestic producers restrict price increases in order to remain competitive against cheap imports. Economists expect that the targeted inflation measure CPIX (consumer inflation excluding mortgage costs) will remain comfortably within the 3 to 6 percent target range for this year. Standard Bank economist Elna Moolman says CPIX will probably remain at the bottom half of the target range for most of the year, peaking at 4.4 percent and averaging 3.9 percent for the full year. The low inflation numbers could leave enough room for the South African Reserve Bank (SARB) to lower interest rates again this year, economists say. Efficient Group economist Nico Kelder says rates could be cut by about 0.5 percentage points next month, and possibly again in April. The SARB kept its repurchase rate unchanged at 7.5 percent in December, citing high domestic spending and uncertainty about the rand's strength as potential inflation risks. Domestic spending gave a boost to economic growth last year, lifting it to an eight-year high of 5.6 percent in the third quarter (on a seasonally adjusted and annualized basis). Efficient Group's growth forecasts are higher than most, with gross domestic product (GDP) estimated to rise 5.7 percent this year, up from an expected 3.8 percent in 2004. Kelder says domestic demand will continue to drive the local economy, but exports are likely to show more substantial growth in the face of a fairly stable exchange rate. Despite the higher growth rates, economists concur that this is unlikely to make a significant dent into the unemployment numbers. South Africa's official unemployment rate, counting only those who are actively looking for work stands at 27.8 percent, or 4.6 million people. The unemployment rate increases to 41.2 percent, or 8.4 million people, when discouraged job seekers are included. The Efficient Group expects the current account deficit to increase, reaching R45 billion ($7.9 billion using 5.7 rands per dollar), or 3.2 percent of GDP in 2005, slightly worse than last year's estimated deficit of R40 billion, or 3 percent of GDP. Source: Business Day, January 4.

SERVICE SECTOR SETA FACES FUNDING CRISIS

¶6. The Services Sector Education and Training Authority

(SETA) has declared a moratorium on new learnerships (apprenticeships) until at least July. The SETA said resumption of its primary activity of starting learnerships in the services sector would be "subject to sufficient discretionary funding availability and satisfactory conclusion of quality assurance issues." The 90,000 companies registered with the SETA will continue paying their skills development levies a total of about R40 million ($7 million using 5.7 rands per dollar) a month to the South African Revenue Service without being able to obtain the benefits for which they are paying. About 80 percent of the fees revert to the SETA, which means that, for at least six months, more than R190 million ($33 million) will be used either to pay the authority's debts or to maintain its infrastructure. Dozens of companies have disputed comments made recently by a SETA spokesperson that claimed that creditors had been paid just before the SETA closed on December 15 for the holiday season. Numerous organizations, including the South African Chamber of Business (SACOB), said they had received no money despite promises of payment. According to SACOB's CEO James Lennox, the Labor Department as well as the SETAs have repeatedly asserted that the skills development levy (which amounts to 1 percent of a company's payroll) is not a tax. The impact of the service sector SETA's actions might be that companies that are participating in learnerships and sponsored skills programs will refuse to participate in the government's job creation initiatives, especially the smaller companies not having enough cash flow to pay the SETA without receiving any benefits. One creditor, the X-Pert project management group, is owed nearly R10 million ($1.7 million) with the amount increasing by more than R700,000 a month because it is carrying the costs for more than 400 apprentices, 55 of whom have physical or other disabilities for which the SETA is responsible. Source: Business Day, January 4.

HARTLEY